No. 15,898

In the

United States Court of Appeals

For the Ninth Circuit

ARTHUR V. MORGAN and DOROTHY O. MORGAN,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for Review of the Decision of the
Tax Court of the United States

Amicus Curiae Brief
In Support of Petitioners

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STATEMENT OF INTEREST

Our interest in this action is as follows:

Thomas T. Files represents the Petitioners in *Edward C. Cadjew and Vivian L. Cadjew v. Commissioner of Internal Revenue,* pending in this Court (No. 16698), which also involves the dealer reserve issue presented in this action.

Alfred E. Holland and Felix S. Wahrhaftig represent

the Petitioners before the Tax Court of the United States in *Charles E. Brown and Dorthea J. Brown* (Docket No. 64959) and *West Coast Trailer Sales* (Docket No. 64960), which also present the dealer reserve issue. These proceedings were set for hearing on the Tax Court calendar commencing October 26, 1959, at San Francisco, California. The Tax Court on October 26, 1959, granted the Petitioners' motions requesting that the proceedings be continued generally, the motions reciting that the final decision in the above-mentioned *Cadjew* case should control and be dispositive of those proceedings.

STATEMENT CONCERNING ARGUMENT OF AMICUS CURIAE BRIEF

We are in accord with the argument set forth in the Brief for the Petitioners and it is not our purpose to reiterate that argument. We shall present additional grounds in support of the Petitioners' contention that income did not accrue at the time credits were made by a bank to a dealer reserve account.

We shall also present, as an alternative to an argument of Petitioners, a middle-ground position as to the extent to which and the time at which the amount of those credits accrued as income. The consideration of this position is respectfully requested in the event the Court does not accept in its entirety the argument in this regard of the Petitioners.

SUMMARY OF ARGUMENT

By virtue of California Civil Code Section 2982(d), the purchaser of a motor vehicle in California under a conditional sale contract does not become unconditionally obligated for the entire amount of the time price differential specified in the contract. That Section authorizes the buyer to satisfy in full the indebtedness evidenced by the contract

at any time before the final maturity thereof through the payment of only a portion of the time price differential. The amount of the time price differential obligation on a satisfaction of the indebtedness before maturity is determined through the application of a formula set forth in the Section and depends upon the number of months the indebtedness would have continued had it not been so satisfied before maturity.

There being no fixed or unconditional obligation on the part of the purchaser of the vehicle to pay the entire amount of the time price differential at the time of the execution of the conditional sale contract, there could not then arise in favor of the seller the fixed or unconditional right to receive that entire amount that is essential to an accrual of income.

The transfer of the conditional sale contract to the bank did not increase the obligation of the purchaser of the vehicle. Similarly, that transfer did not vest in the bank any greater right to the entire amount of the time price differential than was possessed previously by the seller of the vehicle.

In making a credit to the seller's dealer reserve account at the time of the transfer to it of a conditional sale contract, the bank was not unconditionally obligating itself to pay the amount of the credit to the seller either by way of a cash payment or by way of satisfaction of any liability of the seller to the bank. The bank was merely indicating the amount to which the seller would be entitled if the purchaser paid the entire amount of the time price differential rather than the portion thereof which he was obligated to pay on a satisfaction before maturity. In fact, by reason of prepayments by purchasers of vehicles, the bank never became obligated to the seller for the entire amount of the credits to the reserve account.

There being, then, no fixed or unconditional obligation of the bank to the seller for the entire amount of a credit to the seller's dealer reserve account, the entry of the credit at the time of the transfer of a conditional sale contract to the bank did not create in favor of the seller the fixed or unconditional right to that amount that is essential to its accrual as income at that time.

At most, there accrued as income to the seller in 1950 such portion of the amounts credited to the seller's dealer reserve account as was attributable to the amounts of time price differential for which purchasers of vehicles became unconditionally obligated to the bank in 1950.

ARGUMENT

I. The Entire Amount of the Time Price Differential Set Forth in a Conditional Sale Contract for the Sale of a Motor Vehicle in California Does Not Accrue as Income to the Seller When the Contract Is Executed.

California, in common with other States, has experienced difficulties over the years in the administration of its laws governing the maximum amount of interest and finance charges which may be collected in connection with the sale of goods on the installment method of payment. In an attempt to meet the problem as respects motor vehicles, the California Legislature in 1945 enacted Civil Code Sections 2981 and 2982 (11 West's Annotated California Codes). These Sections provided, among other things, for a so-called time price differential, limited the amount of that time price differential, authorized satisfaction of the indebtedness evidenced by the conditional sale contract at any time before the final maturity thereof, and required the acceptance by the seller of a lesser amount than the amount specified as time price differential in the contract

upon the satisfaction of the indebtedness before maturity.

The portions of these Sections pertinent to this proceeding are subdivisions (c) and (d) of Section 2982, which provided as follows:

> "(c) The amount of the time price differential in any conditional sale contract for the sale of a motor vehicle, with or without accessories, shall not exceed 1 percent of the unpaid balance multiplied by the number of months, including any excess fraction thereof as one month, elapsing between the date of such contract and the due date of the last installment, or twenty-five dollars ($25), whichever is greater, provided that such contract may provide for interest on any delinquent installment from and after the date of delinquency, and for reasonable collection costs and fees in the event of delinquency."

> "(d) Any provision in any conditional sale contract for the sale of a motor vehicle to the contrary notwithstanding, the buyer may satisfy in full the indebtedness evidenced by such contract at any time before the final maturity thereof, and in so satisfying such indebtedness shall receive a refund credit thereon for such anticipation of payments. The amount of such refund shall represent at least as great a proportion of the time price differential, after first deducting from such time price differential a minimum charge of not to exceed twenty-five dollars ($25), as the sum of the periodic time balances after the month in which such contract is paid in full bears to the sum of all of the periodic time balances under the schedule of payments in the contract, both sums to be determined according to the monthly balances which would result if the indebtedness were paid according to the terms of the contract; provided, however, that the provisions of this subsection shall not impair the right of the seller or his assignee to receive a minimum time price differential of twenty-five dollars ($25), or to receive inter-

> est on delinquent installments or reasonable collection costs and fees, as provided in subsection (c) of this section; and provided further, that where the amount of such refund credit would be less than one dollar ($1), no refund need be made."

Section 2982 has been held to be merely an extension of the usury laws of the State of California. *Stone v. James,* 142 Cal. App. 2d 738, 740, 299 P.2d 305, 307, citing the exhaustive review of the matter in *Carter v. Seaboard Finance Co.,* 33 Cal. 2d 564, 203 P.2d 758. The obvious purpose of subdivision (d) of the Section is to authorize a purchaser of a motor vehicle to satisfy in full the indebtedness under his conditional sale contract prior to the final maturity thereof and to obligate him on satisfaction prior to maturity to pay only a proportionate part of the time price differential set forth in the contract. Thus, the time price differential is regarded either as interest or as a finance charge inasmuch as the amount thereof which may be collected from the purchaser is made dependent upon the period of time over which the payments extend. The tax Court found that the item in the contract "* * * designated as 'Time Price Differential' consisted of finance charges or interest * * *" (R. 24).

Subdivision (d) sets forth a formula whereby there may be determined the amount to be paid by a purchaser satisfying his indebtedness before maturity. The provisions of the subdivision constitute, of course, a part of each motor vehicle conditional sale contract. *Bell v. Minor,* 88 Cal. App. 2d 879, 881; 199 P.2d 718, 720; *Castleman v. Scudder,* 81 Cal. App. 2d 737, 740; 185 P.2d 35, 37. The effect of the statutory provision, accordingly, is to write into each motor vehicle conditional sale contract a schedule of the various time price differential payments which would have to be

made by the purchaser upon his satisfaction of the indebtedness at any time during the period over which payments were permitted to be made under the contract.

In the light of Section 2982, a purchaser of a motor vehicle under a conditional sale contract has unconditionally obligated himself to pay as a time price differential not a single stated sum, but rather a series of sums increasing in amount with the passage of the time over which his payments may be made. Inasmuch as the purchaser is not unconditionally obligated to pay the entire amount of the listed time price differential, the seller obviously does not have at the time of the execution of the conditional sale contract a fixed or an unconditional right to receive that entire amount.

The amount of the time price differential did not, accordingly, accrue as income to the seller of the motor vehicle upon the execution of the conditional sale contract. *Spring City Foundry Co. v. Commissioner,* 292 U.S. 182, *Commissioner v. Hansen,* 360 U.S. 446. In fact, the action of the Commissioner recognizes that such is the case for otherwise, inasmuch as he has regarded the sale of a motor vehicle and the transfer of a conditional sale contract to a bank as separate transactions, his determination of a deficiency would have been based on the accrual as income to the seller from the sale of the vehicle of the entire amount of the time price differential and the dealer reserve issue here presented would not have arisen. The theory upon which the Commissioner asserted the deficiency in question is, accordingly, diametrically opposed to the accrual of the amount of the time price difference as income when the conditional sale contract was executed irrespective of whether the time price differential be regarded as interest or a finance charge or as a part of the sales price of the vehicle.

II. The Bank Did Not, in Making a Credit to the Seller's Dealer Reserve Account on the Transfer to It of a Conditional Sale Contract, Unconditionally Obligate Itself to Pay the Amount of the Credit to the Seller and That Amount Did Not, Therefore, Accrue as Income to the Seller at That Time.

It is obvious that the transfer of a conditional sale contract to the bank did not in any way increase the obligation of the purchaser of the vehicle under that contract. It is equally obvious that the transfer of the contract did not vest in the bank any greater right to the entire amount of the time price differential than was possessed previously by the seller of the vehicle.

Respondent contends that income accrued to the taxpayer's partnership in the amount credited by the bank to the reserve account of the partnership at the time of the purchase by the bank of a conditional sale contract. The Tax Court unquestionably so held for it stated that "[T]he obligation of the bank to the partnership was an accrued liability at that time." (R. 33). Thus, the Tax Court regarded the bank as having a fixed or unconditional obligation to pay that amount to the partnership, or apply it in satisfaction of the partnership's obligations to it, and the partnership as having a fixed or unconditional right to receive that amount, or have it applied in satisfaction of its obligations to the bank (R. 32, 33).

Yet, the fact remains that the entire amount credited to the partnership's reserve account in 1950 was not ultimately paid to the partnership or applied in satisfaction of its obligations to the bank for the reason that debits were made to that account as a result of prepayments by purchasers of cars (R. 27). The only answer given in the opinion of the Tax Court to this was

> "* * * the possibility that subsequent prepayments by purchasers of cars would reduce the amount in the

reserve does not affect the accruability since such reduction would be the consequence of a condition subsequent." (R. 33)

Respondent similarly asserts merely that

"* * * The prepayment, debiting, and corresponding diminution of the bank's obligation to the partnership must be regarded as a condition subsequent to its liability to pay at the time the sale was made and the credit was entered * * *" (Br. 16)

Whether the reductions in the reserve account resulting from prepayments are in fact or in legal contemplation the consequence of a condition subsequent or whether the statements above quoted are merely of the bootstrap-lifting variety is the core of the matter. We see no basis whatever for the introduction of the condition subsequent concept in this situation.

We have shown that the conditional sale contract did not create immediately a fixed or unconditional obligation of the purchaser to pay the entire amount of the time price differential and that the bank upon the transfer of the contract to it did not have a fixed or unconditional right at that time to receive that amount. Under these circumstances and in view of the arrangement under which the reserve account was debited as a result of a payment prior to the maturity date of a contract, it is completely unrealistic to conclude that the bank was assuming a fixed and unconditional obligation to pay to the partnership any portion of an amount which it did not then have a fixed or unconditional right to receive and which in many instances it did not receive.

The Tax Court did not find as a fact, and we know of nothing in the record which would justify a finding, that the bank, under its agreement with the partnership, had a fixed and unconditional obligation to pay to the partnership

(either by way of cash or satisfaction of a partnership liability to the bank) the entire amount of a credit to the dealer reserve account at the time of the entry of the credit.

Strangely enough, the Tax Court used language of condition rather than of fixed obligation and accrual in stating that

> "* * * the amount of the reserve in excess of a percentage of the aggregate unpaid contract balances is payable to the partnership and the partnership is entitled to the entire balance in the reserve *if* and when all the contracts are paid in full * * *" (R. 32) (Emphasis added.)

The reference to "when" is understandable; that to "if" is not consistent with the view of accrual, particularly when the purchasers were not unconditionally obligated to pay their respective contracts in full in the sense meant by the Tax Court.

Furthermore, it is completely contradictory from the standpoint of accrual theory to assert, at least in the absence of some very compelling reason, that a fixed or unconditional right to receive an amount is subject to divestment as a consequence of a condition subsequent. That which is subject to a condition is not by its very nature fixed and unconditional from the standpoint of accrual. To apply the condition subsequent concept, as did the Tax Court, is, accordingly, to exalt form above substance in derogation of the basic principle of tax law to the contrary. *Commissioner v. Hansen*, 360 U.S. 446, 461.

The factual situation presented in *Michelin Corporation v. McMahon*, 137 F. Supp. 798, furnishes an apt illustration of the impropriety of the use here of the condition subsequent concept. There, property was sold in December, 1945, for $700,000, or $650,000 if the full amount of the purchase price was paid within two years. The purchaser paid $350,-

000 in cash and gave a secured bond in the sum of $350,000. The bond, like the contract, permitted prepayment within two years at a discount of $50,000. In reporting its gain for 1945 from the transaction, the seller computed that gain on a reported $700,000 gross proceeds from the sale. In August, 1946, the purchaser exercised its privilege of prepayment and paid $300,000 in full satisfaction of its obligation. In its return for 1946, the seller deducted $50,000 as a loss to reflect the difference between the $300,000 received and the $350,000 face amount of the bond. The suit was instituted to recover the amount of a deficiency assessed by the Commissioner on the basis of the disallowance of this deduction.

To be sure, the question before the Court was the fair market value of the bond at the time of its receipt in 1945 by the seller. The case is of considerable significance for present purposes, however, for two reasons. In the first place, it is clear from the opinion that the Court was of the view that the right of the seller to the $50,000 was contingent until the two year period had expired. Clearly, the Court would not have distinguished between the accrual of the $50,000 to an accrual basis taxpayer and the inclusion of that $50,000 in the fair market value of the bond. In fact, the Court used accrual of income terminology in stating that

> "* * * *At no time up to the expiration of the two-year period was the debtor unconditionally obligated to pay the sum of $350,000.* To contend that such a bond and mortgage when received by the plaintiff in 1945 had a value of $350,000 is to fly in the face of reality and to disregard common experience * * *" 137 F. Supp. 2d 798, 801. (Emphasis added.)

In the second place, the agreement was phrased in terms of a condition subsequent inasmuch as it provided in the first instance a sales price of $700,000, which could, however,

be satisfied in full by a payment of $650,000 within two years. It is submitted that the Court was entirely correct in stating that

> "* * * Significant facts which the taxpayer appears to have disregarded are that the sales price was not $700,000 but either $700,000 or $650,000 and that the amount payable under the bond was not $350,000 but $300,000 if the purchaser exercised its option. The contract specifically set forth the alternative sales price of $650,000 * * *" 137 F. Supp. 798, 801.

Assume, for purposes of simplicity in discussion, that the property in question had a zero basis in the hands of an accrual method taxpayer. Further assume that the sales agreement provided that the purchaser would pay $650,000 for the property, but then went on to provide that if the entire $650,000 was not paid within two years the purchaser would pay $700,000 for the property. It is hardly to be doubted that, under these circumstances, Respondent would concede that income of only $650,000 accrued at the time of the sale. If the $650,000 were not paid within the two year period, the additional $50,000 would accrue as income at the end of that period. Unless substance is to be completely subordinated to form, exactly the same result should obtain when the agreement, as in the *Michelin* case, provided for the payment of $700,000, but for complete satisfaction of the obligation through a payment of $650,000 within two years. Whether the agreement is expressed in terms of a condition precedent or a condition subsequent should not, accordingly, in this situation control the application of the tax law.

The time price differential involved in the instant case should be regarded in a similar manner. There was no greater obligation cast upon a purchaser of a vehicle from the partnership to pay the entire time price differential set

forth in his contract than was cast upon the purchaser in the *Michelin* case to pay the entire $700,000 set forth in the agreement there involved. It would necessarily follow that the partnership would not be required to accrue the entire amount of the time price differential as income when the conditional sale contract was executed. In both situations, the factors of passage of time and date of satisfaction of indebtedness would determine the amount of the obligation.

There is no greater reason for introducing a condition subsequent concept with regard to the obligation of the bank to the partnership as to the credits to the dealer reserve account than there is for introducing that concept with regard to the obligation of the purchaser of a vehicle to the partnership and to the bank under the conditional sale contract. Furthermore, the arrangement between the bank and the partnership as respects credits and debits to the dealer reserve account of the partnership in no way requires the conclusion that the vehicle purchaser's satisfaction of his obligation under the conditional sale contract prior to final maturity partakes of the nature of a condition subsequent so as to make the bank's debit to the reserve account in a case of such a satisfaction the consequence of a condition subsequent.

Clearly, the bank and the partnership contemplated that the credit to the reserve account based on the entire amount of the time price differential would constitute a fixed and unconditional obligation of the bank to the partnership only if the entire amount of the time price differential was paid by the purchaser of the vehicle.* There is no basis in logic

*In the event of default by the purchaser of the vehicle, the partnership was obligated to pay to the bank the unpaid balance owing on the defaulted contract, less a pro rata rebate of the bank's unearned charges. (R. 22.) The payment made to the bank by the partnership in such a case was, therefore, the equivalent of a payment prior to maturity by the vehicle purchaser and would result in the same debit to the reserve account as would a payment at that time by the purchaser.

or otherwise, accordingly, for the view that an amount credited to the reserve account thereupon accrued as income and that a debit to the account by virtue of a payment prior to maturity was the consequence of a condition subsequent.

From the standpoint, accordingly, of either the factual situation here involved or the general theory of the accural of income, there is no basis for asserting that a debit to the reserve account was the consequence of a condition subsequent as a ground for determining that the prior credit to the account created a fixed and unconditional obligation resulting in an accrual of income to the partnership.

The decision of the United States Supreme Court in *Commissioner v. Hansen,* 360 U.S. 446, does not require a determination in this case that the amounts credited to the dealer reserve account accrued as income to the partnership when credited. That decision is based on the consideration that the amount of the credits would either be paid to the dealer in cash or be used to satisfy the dealer's obligations to the bank. Such is not the case here in view of the debits to the account for prepayments (R. 27).

Then, too, the Supreme Court expressly left open the question of the accrual of percentages of "finance charges." 360 U.S. 446, 468. Here, the Tax Court found that the item of the conditional sale contract "* * * designated as 'Time Price Differential' consisted of finance charges or interest * * *" and that the amount of the credit to the reserve account was the difference between the amount of the time price differential and the discount charged by the bank (R. 24, 25).

Even assuming, *arguendo,* that the time price differential is not a finance charge within the meaning of the Supreme Court's reference or that it has not been established herein that the credits to the partnership's dealer reserve account

had been identified as percentages of a finance charge, the *Hansen* decision does not support the Respondent's position. Under this assumption, which is contrary to the findings of the Tax Court, the time price differential would constitute a part of the sales price of a vehicle, but, as shown above, the conditional sale contract did not create a fixed or unconditional obligation on the part of the purchaser of the vehicle to pay that amount irrespective of how it might be characterized and, unless the Tax Court's condition subsequent position be accepted, the entry by the bank of the credit to the partnership's reserve account did not create a fixed or unconditional obligation of the bank to the partnership for the amount of that credit irrespective of its origin.

Wiley v. Commissioner, 266 F.2d 48, and *Schaeffer v. Commissioner,* 258 F.2d 861, cited by Respondent (Br. 13, 14) were decided in the Sixth Circuit prior to the decision of the Supreme Court in the *Hansen* case. The *Wiley* case involved a reserve account based on finance charges, but the Court of Appeals merely rested its decision, without discussion, on the *Schaeffer* case. The Tax Court opinion in the *Wiley* case relied upon the condition subsequent approach of the decision here under review. 16 T.C.M. 1089.

The *Schaeffer* case is distinguishable from the instant case in that, as in the *Hansen* case, the amount of the credits to the reserve account would be paid to the dealer or applied to the payment of the dealer's obligations. 258 F.2d 861, 864. Furthermore, the Court there determined that the entire amount of the vehicle purchaser's contract obligation accrued to the dealer (258 F.2d 865), which we have shown not to be the situation under California law.

III. At Most, There Accrued as Income to the Partnership in 1950 Such Portion of the Amounts Credited to the Partnership's Reserve Account as Was Attributable to the Amounts of Time Price Differential for Which Purchasers of Vehicles Became Unconditionally Obligated to the Bank in 1950.

It is not our intent to express disagreement with the Petitioners' contention as respects the time of accrual of the amounts credited to the partnership's dealer reserve account. We wish merely to offer an alternative position for consideration in the event the contention of the Petitioners in this regard is not accepted.

We believe that we have established that the entry of a credit by the bank to the partnership's reserve account did not at that time result in an accrual of income to the partnership in the amount of the credit. Admittedly, however, such portion of the amount of those credits as inured to the benefit of the partnership either by way of payments in cash or by way of satisfaction of obligations accrued as income to the partnership at some time.

In the light of the foregoing discussion, it is fundamental that, at most, there accrued as income to the partnership in 1950 such portion of the amounts credited to the partnership's dealer reserve account as was attributable to the amounts of time price differential for which purchasers of vehicles became unconditionally liable to the bank in 1950. By the end of that year the liability of each purchaser of a vehicle for that portion of his contract's time price differential which could no longer be abated under Civil Code Section 2982(d) would have become fixed and unconditional.

Were all the contracts fully satisfied either by virtue of their maturity or their satisfaction in full prior to maturity at the end of 1950, all the debits to the reserve account required as a result of prepayments would have been made and the credit balance in the account could be said to con-

stitute a fixed or unconditional obligation of the bank to the partnership. An amount equal to that balance might similarly be regarded as a fixed or unconditional obligation of the bank to the partnership, inasmuch as it was the portion of the credits to the reserve attributable to the amount of time price differential for which the vehicle purchasers were unconditionally obligated, even though many of the contracts executed in 1950 were not fully satisfied in that year. This does not mean that the partnership would have been entitled to receive a payment from the bank in the amount so regarded as having accrued to it as income in 1950 for that amount would still be held by the bank as security for obligations of the partnership to the bank.

The accrual of income to the partnership from the credits to its dealer reserve account in this manner involves recognition of the principle of the *Hansen* case that an amount accrues as income when the dealer's right to it becomes fixed and it eventually will be paid to him or applied in satisfaction of his obligations and of the basic principle that an amount accrues as income to the partnership only when it has a fixed and unconditional right to receive it.

CONCLUSION

Income did not accrue to the taxpayer's partnership in 1950 upon the transfer by the partnership to a bank of conditional sale contracts and the crediting of amounts by the bank to a dealer reserve account of the partnership. At most, income accrued to the partnership in 1950 by reason of the reserve account in a lesser amount than the credit balance of the account at the end of that year.

Respectfully submitted,

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